DEPARTMENT OF STATE REVENUE

01-20171269.SLOF

Supplemental Letter of Findings: 01-20171269
Individual Indiana Income Tax
For the Years 2013 and 2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Letter of Findings.

HOLDING

On rehearing, the Department continues to disagree with Indiana Shareholders' claim that they met their burden of establishing that Fiberglass Fabricator provided the specific, contemporaneous documentation sufficient to establish that the individual shareholders were entitled to the flow-through qualifying research expense credits attributable to the Fiberglass Fabricator's development and manufacture of fiberglass prototypes.

ISSUE

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Supporting Documentation.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Suder v. Commissioner*, T.C. Memo 2014-201 (U.S. Tax Ct. 2014); *Union Carbide Corp. and Subs v. Comm'r*, T.C. Memo 2009-50 (U.S. Tax Ct. 2009); *Indiana Dep't of State Rev. v. Caterpillar, Inc*., 15 N.E.3d 579 (Ind. 2014); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin*., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41; I.R.C. § 6001; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2; Treas. Reg. § 1.6001-1; Letter of Findings 02-20200332 (November 17, 2020); Merriam-Webster, https://www.merriam-webster.com/dictionary/experiment.

Taxpayers argue that their fiberglass fabrication company conducted qualified, experimental research activities, that they can adequately document the wage, supply, and contract expenses related to those projects, and that they are therefore entitled to claim the benefit of the flow-through credits associated with their company's qualifying research activities.

STATEMENT OF FACTS

Taxpayers are individual shareholders of an Indiana company ("Company") in the business of designing, developing, and producing fiberglass products. The products include car, truck, agricultural, and railroad parts. Company is organized as an S-Corporation with its income and losses passed through to Taxpayers who, in turn, report the income on their individual income tax returns.

The Indiana Department of Revenue ("Department") conducted an audit review of Company's 2013 and 2014 income tax returns and business records. Except for issues related to research expense credits ("RECs"), the audit examination "revealed no errors to the Indiana adjusted income Indiana modifications."

The audit found that Company claimed Indiana RECs during 2010 through 2014. Company indicated that the RECs were based on the results contained within an REC study prepared by a third-party consultant ("Consultant").

Specifically, Company claimed approximately $4.3 million dollars in expenses related to the development of Company's fiberglass products. As such, Company claimed approximately $300,000 in Indiana tax credits.

After reviewing the REC study and the claimed credits, the Department concluded that Company failed to establish that Company's development and manufacturing activities constituted "qualified research" and that

Company failed to establish that the labor expenses - on which credits were largely based - directly related to the claimed qualifying activities. In reviewing the labor expenses, the Department concluded that Company's "time tracking" records did not represent the actual amount of time spent by Company's employees on qualified research activities and could not be used to factually support the Qualified Research Expenses ("QREs") originally claimed.

The audit also found that Company failed to establish that it was entitled to claim RECs based on the cost of supplies consumed during Company's research activities and that Company was not entitled to claim RECs based on "contract research."

The Department's audit's decision disallowing the credit did not result in the assessment of additional income tax for Company because Company was organized as a S-Corporation. As the audit report notes, the "[Company's] income and credits are passed through to the shareholders on Schedule K-1 . . ."

As a result of Company's audit and the denial of the RECs, Taxpayers were assessed additional individual income tax. Taxpayers disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. A Letter of Findings was issued on November 28, 2018. The "Holding" portion of the 2018 Letter of Findings provides:

> Individuals were unable to provide sufficient documentation to establish that the research expense credits claimed by a flow-through business in which Individuals were shareholders were valid. Therefore, Individuals were unable to claim the research expense credits on their individual income taxes.

Taxpayers disagreed with the conclusions of fact and law contained in the Letter of Findings and petitioned for an administrative rehearing in a letter dated January 4, 2019. Taxpayers objected to the LOFs' conclusion and stated that they were prepared to provide information that would substantiate the amount of credits claimed. The rehearing request was granted in a letter dated September 10, 2020. The rehearing was granted with the understanding that Taxpayers were then prepared to substantiate their claim to the RECs at issue.

The rehearing was conducted by teleconference on November 9, 2021, during which Taxpayers' representative explained the basis for the protest. This Supplemental Letter of Findings was prepared in response to the rehearing request and to any additional documentation provided.

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Supporting Documentation.

DISCUSSION

A. The 2018 Letter of Findings and Issues Addressed in this Supplemental Letter of Finding.

The 2018 LOF denied the protest based on the confluence of two different issues; the first was whether Taxpayers were able to clearly define the nature and extent of the research and experimentation activities fundamental to any claim to the credits. As explained in the LOF:

> For the projects included in [Company's] third-party prepared study, the Department was not convinced that any qualified for the REC. After review of these [supporting] materials, however, the Department remains unconvinced that any of the projects included in the study and reviewed in the audit qualify for the REC.

The second issue was whether Taxpayers were able to document the extent and cost of those qualifying activities. The 2018 LOF found they could not, explaining as follows:

> [B]y Indiana's own documentation standards Taxpayers have not properly recorded or documented [Company's] substantiation of the REC. Therefore, *regardless of whichever federal regulation applies*, Taxpayers do not meet their burden under IC § 6-8.1-5-1(c) to qualify for the Indiana REC.

The LOF addressed Taxpayers' concerns that the Department erroneously applied a restrictive "discovery" test rather than the more fulsome "uncertainty" test in determining whether Company's activities qualified for the credit. Reams of paper and hours of time have been expended by both Indiana taxpayers and the Department in addressing this particular issue. For purposes of this Supplemental Letter of Findings, the Department will set aside well-trodden issues of "uncertainty" and "discovery" because the distinction - even if applicable - is not required to address Taxpayers' concerns.

B. Burden of Proof.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; in every assessment case, each taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin*., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "[A]ll statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc*., 15 N.E.3d 579, 587 (Ind. 2014). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Id.* at 583.

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000).

Every taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). (*See also* IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009); *See also New Colonial Ice Co. v. Helvering*, 292 US 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

C. The Department's Audit Threshold Conclusions.

1. Qualifying Research Projects.

I.R.C. § 41(d) sets out a four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. § 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C). All four tests must be satisfied in order to qualify for the credit.

(a) Eliminating Uncertainty.

In a point-by-point analysis, the Department's audit considered whether Company's activities met each of the four-part tests set out in I.R.C. § 41. In considering first the "elimination of uncertainty" test, the Department's audit report cited to Treas. Reg. § 1.174-2(a) in concluding that Company's employees had the experience to undertake the resolution of any uncertainty involved in meeting its customers' requests. In Taxpayers' case, Company receives a request for a quote, the customer supplies Company with a design drawing, Company's design team prepares a response and meets with the customer, and the design team incorporates into the design any customer requests or modifications. Once Company receives customer approval, the result is digitized into a form from which a mold is prepared. That mold is sent for customer approval. Once customer approval is obtained, Company prepares additional molds which are used to manufacture the finished product. The audit found all of these costs are those "of a normal manufacturer engaged in activities for various clients." As explained in the audit report:

> Qualified research was not readily apparent from any documentation sent to the auditors by [Consultant]. The documentation received pointed to the [Company] doing what is required to be done in the normal practice of the manufacturing industry.
>
> . . . .

> The [Company] is a manufacturer that is hired by other manufacturers to perform normal business activities for which they are qualified to solve the problems presented by the contract requirements. The uncertainty is primarily of a monetary nature and involves economic risk rather than the technical risk as required for research qualification.

(b) Discovering Technological Information.

The report concluded that Company's cited activities did not meet the "discovering technological information" test required under Treas. Reg. § 1.41-4(a)(3)(i) because Company's activities "were not qualified research under either a "discovery" or "uncertainty" standard. As explained in the audit report:

> [Company] failed to meet the second step of the four-part test for all projects that were sampled. These projects do not exceed, expand, or refine the common knowledge of the individuals performing the activities. [Company] is simply creating molds and patterns that are utilized in the manufacturing of fiberglass product.

In effect, the audit found "undeterminable" the extent of which Company expanded upon the common knowledge of those engaged in preparing and fabricating fiberglass molds.

(c) The Process of Experimentation.

In considering the fourth test, the audit relied on Treas. Reg. § 1.41-4(a)(5) (TD 8930) in concluding that Taxpayers did not meet the "undertaking a process of experimentation" component. The regulation provides:

> A process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain.

As explained in the audit report, "[Company] utilizes tried and proven methods to perform its work and it did not test any alternative ways of creating the required products through the process of experimentation." Further, "[Company] failed to provide documentation describing any planned tests, the gathering of test data from such a test or group of tests or the analysis of that data using an application of the scientific method as required under Section 41."

In other words, Company had the capability of fulfilling is customers' design and fabrication requirements because Company has the experience and trained personnel necessary to meet those requirements with resorting to a systematic scientific process of investigatory experimentation. ("Experiment" or experimentation is defined as a "an operation or procedure carried out under controlled conditions in order to discover an unknown effect or law, to test or establish a hypothesis, or to illustrate a known law.") Merriam-Webster, https://www.merriam-webster.com/dictionary/experiment. (Last visited November 21, 2021).

(d) Developing a New or Improved Business Component.

The Department's report concluded that Company failed the "new or improved business component" test because Company failed to establish that is activities were not excluded under I.R.C. § 41(d)(4). The regulation provides that certain activities are "excluded" from taking credit. Those activities include "adaption of existing business components" and "research after commercial production." In reviewing Company's records, the audit found that Company's records reflected costs which were "primarily . . . yearly model design changes." As such, the audit questioned whether routine model changes "would meet the four-part test and be deemed qualified research."

In addition to the reservations cited above, the audit report indicates that "[Company] failed to supply contracts and other documentation to determine whether the projects may have been for research after commercial production reproduction of an existing business component, and/or funded research." As further explained:

> The auditors question whether the model changes from year to year are qualified research or if the projects would fall under duplication due to the [Company] creating a new mold by duplicating in whole or in part a previous mold . . . . [S]ome of the research pertained to a left hand versus right hand fiberglass product, driver side versus passenger side panel, or front for 2011 versus a future year model.

As to "improved business component" test, the audit concluded that "[t]he lack of documentation made it impossible for the auditors to determine whether or not the projects were a duplication or not."

D. Documenting and Substantiating the Credit.

Both the 2018 LOF and audit report found that Company failed to substantiate qualification for the credit to substantiate the amount of the credit.

The audit cited to Treas. Reg. § 1.41-4(d) which sets out the record keeping and documentation requirement for expenses related to the REC:

> No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations there under.

In turn, Treas. Reg. § 1.6001-1(a) - referred to above - provides:

> Any person required to file a return of information with respect to income shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information.

The audit report also pointed to Indiana's own general record keeping requirement.

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks. IC § 6-8.1-5-4(a).

The audit report summarized the standard under which it evaluated Company's efforts to verify the labor expenses. "The common theme of . . . the legal authorities . . . is that the taxpayer must keep records to substantiate the amounts reported on returns filed by the taxpayer." Under the relevant regulation, Treas. Reg. § 1.41-4(d), the claimant "claiming a credit under Section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit" and the claimant "prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain . . ."

The audit pointed out that Company did not use a project accounting that provided sufficient detail to determine the appropriate REC on a project-by-project basis. Given that lack of documentation and the shortcomings associated with Company's perceived inability to demonstrate that its activities met the four-part test called for under Treas. Reg. § 1.41-4 the Department's audit disallowed the credits claimed.

Under either the "discovery" or "uncertainty" standards, the audit concluded that "[T]axpayer has not provided . . . contemporaneous documentation . . . to support the employee research participating percentages that it used to calculate the QREs.

E. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayers state that Company "performed qualified research activities," that they were "entitled to the Credit," and the "assessment [is] wrong." According to Taxpayers:

> [T]he Department must determine whether [Company] performed qualified research in the years at issue and, therefore whether [Company] performed such activities on any projects is material to this matter. (Taxpayer's emphasis).

It is Taxpayers' position that if it conducted any qualified research activity, the audit's results were wrong, Company would be entitled to the credit, and the assessment of additional tax is wrong.

Specifically, Taxpayers point to a particular project which, according to Taxpayers, clearly establishes that Company undertook qualifying research activities and that it spent money to do so. Company undertook a project to develop a fiberglass railcar cover and a device which would automatically open the cover upon delivery of the railcar's project. Company estimated that improved aerodynamic railcar cover would reduce fuel costs by 8 to 15 percent.

Specific to the railcar project, Taxpayers provided project notes, computer renderings, design concepts, cost estimates, drawings, CAD drawings, test protocols, and photographs documenting the testing of a prototype cover. That documentation included information about "latch validation", wind and vibration effects, and "extreme testing up to 7g's."

As to the remaining projects, Taxpayers state that "[Company's] activities encompassed development of new or improved products and manufacturing processes." In developing those products, "[Company] was uncertain, at the very least, as to the appropriate design of the new custom project or manufacturing process." Taxpayers admit that it has experience in developing its products but that it "continued to explore new developments with each new or improved product and manufacturing process."

Taxpayers conclude as follows:

> For the tax years at issue, [Company] undertook an evaluative multi-phase development process to achieve the appropriate product design and meet all projects while overcoming uncertainties . . . [B]oth [Company] and the customer underwent an iterative design process to incorporate new requirements or make additional improvements to the design.

In support of their conclusions, Taxpayers point to various other projects undertaken by Company. For example, "[Company] undertook [a] project to design a fiberglass cap for the front of a fifth wheel trailer." In another project, Company "undertook [a] project to design and develop a fiberglass cap for the front end of a travel trailer." In yet another cited example, Company was tasked by its customer to develop wheel flairs and steps for a Lexington automobile.

Taxpayers summarize the basis for their Company's claim:

> [Company] undertook qualified research activities to design and develop new or improved fiberglass designs . . . . These fiberglass products were developed with emphasis on improving the performance, quality, function, and reliability.

2. Wage Expense Documentation.

At the core of Taxpayers' documentation argument, Taxpayers conclude that neither the Internal Revenue Code nor Treasury Regulations "contain any specific requirement that a taxpayer capture the cost of its research under a certain approach." As a result, the documentation requirement imposed under the audit "demonstrates the exam team's failure to understand the requirements a taxpayer must meet to substantiate the research credit, and well as its *lack of effort to understand the documents that were provided*." (*Emphasis added*).

Taxpayers argue that the Department's record-keeping standard is in contravention of Congress's intent in implementing the credit at the federal level. According to Taxpayers, the only R&D record keeping is found at I.R.C. § 1.600 which imposes "a general recordkeeping requirement that every taxpayer [] maintain accounting records that will enable the taxpayer to file a correct return of taxable income each year."

Taxpayers also argue that contrary to the Department's longstanding interpretation of the REC requirements and the original LOF's analysis, "[T]he IDOR is barred from demanding specific documents and disallowing [credits] due to their lack of production including here whether the audit demand[ed] documents of 'time actually spent' on qualified research activity."

In support of this contention, Taxpayers cite to *Union Carbide Corp. and Subs v. Comm'r,* T.C. Memo 2009-50 at *197-98 (U.S. Tax Ct. 2009) and *Suder v. Commissioner*, T.C. Memo 2014-201 at *25 (U.S. Tax Ct. 2014) for the proposition that costs attributable to Company's "iterative" process of "design[ing] patterns for fiberglass products," "designing curing processes," "overcoming uncertainties," and "evaluating dimensions" qualify for the

REC because each represents a process of a taxpayer's experimentation. According to Taxpayers' interpretation of these cases, the petitioners both correctly "relied upon estimations based on, among other things, interviews with individuals . . . and other unrelated documentary information." Again, in reliance on *Union Carbide*, "[T]he IRS accepted Union Carbide's presentation of base period expenses and project descriptions as a close approximation of all the qualified research activities that occurred during the base period."

Taxpayers conclude that the evidence underlying Consultant's study is sufficient to support its claim that it spent $4.3 million dollars to address fiberglass fabrication issues and that it is now entitled to a $300,000 Indiana credit. The Consultant's study is based on evidence stemming from a "Quote File Query" listing all of Company's activities. After reviewing 18 potentially qualifying projects, Taxpayers and Consultant "determined that all eighteen of the reviewed projects met the requirements of Section 41 of the Internal Revenue Code . . ."

After determining that all 18 projects qualified for the REC, Consultant conducted interviews with Taxpayers - the President and the Director of Operations. Based on a statistical analysis of the projects, interviews, and W2 statements, Consultant determined the amount of time specific employees engaged in these qualifying activities. In doing so, Consultant found that - in some cases - certain employees spent more than 80 percent of their time conducting research and, as a result, Company was entitled to claim 100 percent of those employees' wages.

F. Analysis and Conclusion.

Taxpayers effectively seek an administrative decision in the which the Department finds that the audit's position was meritless and that there are no remaining factual or legal disputes. The decision Taxpayer seeks is one in which the Taxpayers' assessments are abated and the credits reinstituted based on the contention that Company spent some undetermined and unverified amount of money on R&D activities.

The Department's audit, Taxpayers' protest, the original Letter of Findings, the request for rehearing, the rehearing itself, and this Supplemental Letter of Findings are all centered around basic tax issues and not whether Company's employees perform skilled, complex or difficult work. Simply put, the issue is determining whether the $4.3 million dollars claimed expenses and the $300,000 of credits are or are not the right numbers.

The Department's audit found that Taxpayers failed to answer that fundamental question. Without unnecessarily repeating the audit's analysis, the conclusion was that "[Company] did not use a project accounting system with sufficient detail that could be used to determine the appropriate REC pursuant to the project basis." Specifically, the audit report cited I.R.C. § 6001 and Treas. Reg. § 1.6001-1 for the audit's proposition that an REC claimant "must have contemporaneous documentation that was prepared before or in the early stages of research project that describes the principal questions to be answered and the information the [claimant] seeks to obtain."

In their rehearing request, Taxpayers essentially conclude that if the Department finds that Company conducted any qualifying research activity it is entitled to the credit. Taxpayers point to the testing and research activities associated with its proposed fiberglass railcar cover projects (a project which ultimately failed). It is entirely possible Taxpayers are correct; Taxpayers provided a photo of a "test bed" designed to measure the stress and strains on a prototype cover. Moreover, Taxpayers point to documentation of its railcar cover testing protocol and test results. The Department agrees that - given sufficient documentation - Company could well be entitled to the REC for the labor, supply, and contract costs associated with the research and experimentation expended to develop the prototype railcar cover. Taxpayers' assertion leads to the necessary conclusion that Company is engaged in qualifying research activities but the issue here is whether those numbers are correct. Can Taxpayers establish with any certainty that the amount of expenses and the amount of credits claimed is correct?

In Taxpayers' case they rely entirely on the results of Consultant's study which, in turn, rests on estimates, interviews and the recollections of its leadership team none of which meet the documentation standard required to qualify this case for the credit. As with any tax matter, there must be something tangible and measurable at the core of any claim to a credit or expense whether that be a withholding return, receipt, pay stub, or timesheet. Taxpayers did not provide this. Instead, Taxpayers base their claim on employee activities, supplies purchased, and contracts fulfilled which took place during 2010 through 2013 all of which rely on employee interviews and "statistical sampling plans." For example, Taxpayers claim that Company's president spends 80 percent of his time (qualifying for the "substantially all" 100 percent credit) conducting experimental research on the development of new and improved fiberglass products which "refines the knowledge that exceeds, expands, or refines the common knowledge of skilled professional in a particular field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(i).

The Department does not deny the possibility that some or all these employees (including its president) may have

engaged in qualifying research and experimentation. However, Taxpayers do not merely ask that the Department agree with that premise. Instead, it asks the Department to simply agree that it paid approximately $4.3 million dollars to perform those specific qualifying activities. The Department reminds Taxpayers of its long-held position on the documentation issue:

> Indiana case law speaks clearly and plainly to the issue of the documentation required to establish one's entitlement to credits such as that sought by Taxpayers. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law.**" *RCA Corp.*, 310 N.E.2d at 100-01. (**Emphasis added**). Thus, every taxpayer's claims against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project."

If that standard is unclear, the Department has repeatedly held that it would not allow credits or refunds based on what it has colloquially called the "take our word for it" standard which is wholly at odds with the court's "narrowly construed" standard. *McFerrin*, 570 F.3d at 675.

> [T]he Department is asked to allow credits on what is essentially a "take our word for it" (TOWFIT) standard, and although the Department does not question the good faith and veracity of claimants, it does find the TOWFIT standard on which a claimant may rely unworkable, unverifiable, and inconsistent with both the law and common sense. Simply put, Department finds that reliance on the TOWFIT standard is wholly at odds with the Indiana case law which requires that a taxpayer's claim to income tax credits must be established with "sufficient evidence" which is "clearly within the exact letter of the law." *RCA Corp.*, 310 N.E.2d at 100-01. Letter of Findings 02-20200332 (November 17, 2020), 20210127-IR-045210012NRA.

The Department finds that Taxpayers have not met their statutory burden under IC § 6-8.1-5-1(c) of establishing that the assessments were "wrong." Simply put, Taxpayers and Company have not provided anything substantive which can be audited. The Department finds that Taxpayers have not "clearly" established" that they spent $4.3 million dollars researching the development of new and improved fiberglass products during the years at issue. To find otherwise would be entirely speculative and contrary to basic precepts of tax law.

Finally, the Department takes issue with Taxpayers' assertion that the audit exhibited a "lack of effort to understand the documents that were provided." There is nothing in the documentation provided by either the Department or Taxpayers which establish in any way whatsoever that the audit team failed in its responsibilities to properly, and in considerable detail, analyze the facts and implement the law.

FINDING

Taxpayers' protest is respectfully denied.

December 15, 2021

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